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INNOVATIONS IN DEBT MARKET DEVELOPMENT IN EUROPE AND EURASIA

CASE STUDIES



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ACRONYMS

BGN	Bulgarian Lev
BHW	Bank Handlowy
CEO	Chief Executive Officer
CFO	Chief Financial Officer
DEG	Deutsche Investitions und Entwicklungsgesellschaft
DMDI	Debt Markets Development Initiative
EBRD	European Bank for Reconstruction and Development
EIB	European Investment Bank
EMG	Emerging Markets Group
EUR	Euro currency
FSC	Federal Securities Commission (Russia)
IFC	International Finance Corporation
IFIs	International Financial Institutions
IMI	Internationale Micro Investitions Aktiengesellschaft
KfW	Kreditanstalt für Wiederaufbau
LLC	Limited Liability Company
MICEX	Moscow Interbank Currency Exchange
MSMEs	Micro, Small and Medium-sized Enterprises
OJSC	Organized Joint Stock Company
OTC	Over-the-Counter
PLN	Polish Zloty (currency)
QIG	Qualified Investors' Group
RUR	Russian Ruble
SEC	Securities and Exchange Commission
SEE	South-East Europe
SMEs	Small and Medium-sized Enterprises
SPV	Special Purpose Vehicle
TP	Telekomunikacja Polska SA
USAID	US Agency for International Development
WIBOR	Warsaw Interbank Offered Rate



INTRODUCTION

Background

In a number of countries in Europe and Eurasia, the elements necessary for a sustainable market for non-bank financial instruments are in place. Legal foundations are beginning to firm. Confidence in markets is growing. Domestic corporate debt instruments are being issued. Furthermore, strong growth in mortgage lending is providing feedstock for the development of mortgage-backed instruments.

Though barriers to further development of debt markets still exist, market players are forging out on their own, teaming up with others to devise inventive ways of overcoming these barriers. In doing so, they are making notable progress in debt market development. Several such innovations were brought to light and examined during a Domestic Debt Markets Development Initiative conference. This conference was organized by the Emerging Markets Group, Ltd. (EMG), an independent firm associated with Deloitte Touche Tohmatsu. The conference was organized on behalf of the United States Agency for International Development (USAID), and was held in May 2003 in Budapest, Hungary.

Europe and Eurasia Bond Issuance Case Studies

As a follow up to the DMDI conference, EMG and USAID looked to build upon some of the debt issuance examples presented at the Budapest conference. The case studies provide detailed descriptions of innovations in debt markets within the Europe and Eurasia region. Specifically, case studies detail key barriers and constraints, transaction approach and methodology, results and impact, key success factors in overcoming barriers and constraints, and lessons learned as to how this approach could be replicated in other markets.

The case studies presented in this document provide examples of innovative and successful debt issuance across a wide spectrum. Micro, small and medium sized enterprises (MSMEs) are gaining vital local funding through their local bond issuances. Mortgage financing can be increased significantly by the creation of mortgage-backed bonds. Special purpose vehicles have been created to pool risks, construct a collective guarantee mechanism, and provide opportunities for debt financing to raise funds for investment activities. Local currency, long-term corporate public bonds have been issued, thereby developing long-term corporate bond markets. The case studies include the following:

- Issuance of a ***local currency bond by KMB Bank Russia***. KMB Bank was established to provide credit to micro, small and medium-sized enterprises. This unique local currency bond has helped to meet the growing credit needs of MSMEs in Russia.
- Issuance of a ***mortgage bond by ProCredit Bank (Bulgaria)***. Like KMB Russia, ProCredit Bank (Bulgaria) is owned by international financial institutions specializing in lending to micro, small and medium sized enterprises. This mortgage bond issue helped fund the main activity of the Bank, namely, lending to MSMEs.
- Design of an ***innovative, modified SPV to issue a corporate bond in Russia***. Alfa Bank worked with Amtel Group to develop an innovative approach to issuing debt, by making use of a modified special purpose vehicle. This bond helped to raise funds to finance Amtel Group's operating activities and investment projects.
- Issuance of a ***long-term, local currency corporate public bond by Polish Telecom***. Bank Handlowy, a member of Citigroup, worked with Polska Telecom to issue the first public long-term corporate bond program for the Polish market. It was instrumental in paving the way for legislative changes that simplified the process for arranging public bond offerings, thereby helping to develop the long-term corporate bond market in Poland.



CASE STUDY #1: LOCAL CURRENCY CORPORATE BONDS IN RUSSIA

KMB BANK: MEETING THE GROWING CREDIT DEMANDS OF SMALL AND MEDIUM ENTERPRISES

1. Overview

THE ISSUER

KMB Bank was founded in 1999 by the European Bank for Reconstruction and Development (EBRD) for the purpose of lending to micro, small and medium-sized (MSME) businesses.¹ KMB's other shareholders are the Soros Economic Development Fund, the German development organization DEG (Deutsche Investitions und Entwicklungsgesellschaft); and Stichting Triodos-Doen, a Dutch economic development fund.

As of the end of 2003, KMB had a total loan portfolio of approximately \$200 million. Out of a total of 29,157 loans, 6500 of KMB's loans were for amounts of under \$1000, while loans under \$20,000 constituted 39 percent of the total portfolio. Also as of year end 2003, the bank had 1027 employees, 7 branches, 15 representative offices, and a presence in 22 regions, including Siberia and the Russian Far East. KMB obtained its first international rating in December 2003, when Moody's assigned it a rating of Ba3 for its long term bank deposits. This rating compares favorably with Moody's Baa3 rating for Russian sovereign debt.

Summary of Deal

Country:	Russia
Issuer:	KMB Bank
Offering Type:	Private Placement of non-secured corporate debt
Amount:	RUR 280 million (\$9.7 million)
Issue Date:	October 24, 2002
Maturity:	3 years

THE NEED FOR BONDS

The ruble market in Russia has historically been underdeveloped, for several reasons. First, lack of confidence in the ruble since the hyperinflation of the early 1990s led many businesses and individuals to prefer to use the dollar when possible as their primary currency. Also, the largest single holder of rubles is Sberbank, the majority state-owned savings bank; because of its comparative advantage in being able to lend in rubles, Sberbank has no incentive to use its ruble holdings to develop an interbank market to facilitate ruble lending by other banks. A third important factor has been the lack of any apparent Government policy to develop a ruble market, such as by creating a long term ruble yield curve that borrowers and lenders could use to establish benchmark interest rates. As a result of these and other factors, Russian banks (with the exception of Sberbank) have not historically had sufficient long term ruble funding – whether from client deposits or interbank funding – to be able to provide extensive long term ruble financing to their clients.

The situation began to change in the early 2000 period, which was characterized by a significant increase in ruble liquidity throughout the economy, due largely to high oil prices. Companies with high levels of ruble balances were largely limited to investing them in government securities. Placing long term

¹ The EBRD had previously had a successful Russian MSME lending program that was implemented by a number of Russian banks, but the Russian financial crisis of 1998 and the related problems in the banking sector led to a significant decline in the number of the EBRD's partner banks and therefore the EBRD's decision to found KMB as a bank specializing in serving MSME clients.



deposits with banks was not a realistic option; the lack of a long term yield curve noted earlier made banks hesitant to take the risk of committing to pay a fixed interest rate over a long period of time. Furthermore, lingering concerns from the 1998 banking crisis made many companies unwilling to place their funds in banks for a long time period.

Russia's financial markets responded to this gap between a growing supply of rubles and unmet demand for ruble funding by creating debt instruments that by-passed the banks and enabled borrowers to raise rubles directly from the market. (Although Russia did have a bond market that was regulated by the Securities Commission, intensive disclosure requirements made issuing publicly tradeable bonds a time-consuming and expensive undertaking that was feasible only for few large companies.)

The inability of banks to obtain adequate ruble funding was particularly a problem for a bank like KMB, most of whose clients do not do business internationally and, therefore, should optimally borrow in rubles to match their ruble revenues. KMB's shareholders could and did provide long term funding to KMB, as did other banks. However, these organizations also did not have a source of ruble funding and therefore lent to KMB in dollars or euros.² With approximately half of its loan portfolio denominated in rubles, KMB raised rubles in the short term interbank market in order to meet client demand for ruble loans (approximately half of KMB's loan portfolio was in rubles), but using short term funding to make longer term loans was clearly not a viable long term practice. The development of a ruble debt market therefore gave KMB the much sought after opportunity to obtain longer term ruble funding.

It should be stressed that the ruble debt market was the only source of long term ruble funding for KMB at the time of its first debt issue in 2002; the underdevelopment of the ruble market overall did not provide KMB with other possible options for raising such funding. However, it is relevant to note that tapping the market also provided KMB with a welcome opportunity to further develop its reputation in the local financial markets, create a public credit history and broaden its access to potential funders.

THE LOCAL DEBT MARKET

The domestic ruble debt market developed extremely quickly, reflecting both the high liquidity noted earlier as well as the relative lack of regulation. The fact that during 2003 some of the most highly rated borrowers were raising funds at below the ruble inflation rate illustrates the pent-up demand for ruble-denominated investments. Investor enthusiasm has become more moderate during 2004, reflecting the near-default of one issuer and the uncertainty created by the Yukos problems and the mini-crisis in the banking sector.

A notable potential weakness in the evolving ruble debt market is that it typically arranges multi-year borrowings with short term put options by the debt holder. This is clearly quite a risky way to structure a borrowing, because there is no guarantee for the borrower that it might not have to buy back the entire debt issue on a put date. As investors and borrowers become more comfortable with the market the put dates are becoming longer; whereas initially they were at six month periods, now it is more common for them to be at one year periods. However, if a significant problem developed in the market, such as a loss of confidence, the prevalence of these put options could have a domino effect as borrowers scramble to raise the funds to buy back their debt.

² The EBRD explored a variety of ways to raise rubles for KMB (and other borrowers), including issuing its own ruble debt that it could then lend to KMB and guaranteeing KMB's borrowing of rubles from third parties. None of these possible alternatives had come to fruition by the time of KMB's debt issue.



2. Barriers, Constraints, and Opportunities

LEGAL/REGULATORY ISSUES

The KMB debt issue was limited to approximately \$9.7 million, due to Russian regulations that prohibit issuers from raising more than the amount of their capital. The size of the debt issue had cost implications for KMB, as the fee for the investment bank was proportionally higher than it would have been on a larger issue. Also, because small issues are less liquid than large issues, investors typically charge a liquidity premium that raises the overall cost.

KEY ISSUES SPECIFIC TO THE ISSUER

KMB entered the market with the advantages of good –and improving – financials, a commitment to transparency, reliable international shareholders, and a ruble debt market that was growing rapidly. Nevertheless, because KMB's core business of lending to MSMEs is unusual for the Russian market, it was necessary to familiarize potential investors with the characteristics of KMB's business.

3. Deal Assembly and Structure

DEAL STRUCTURE

Because of the relatively small size of the debt to be raised, the transaction was structured as a private placement. A private placement had the advantage of less extensive – and less expensive – disclosure requirements and regulatory approvals than bonds issued with the approval of Russia's Securities Commission.

The three-year term of the issue was chosen because it corresponded to the structure of KMB's loan portfolio and was also the maximum term perceived to be acceptable in the market. Six month put periods were also considered the most attractive for the market by a first-time issuer. A fixed coupon of fifteen percent was assigned to the bonds, recognizing that the market price would be determined by the price at which the bonds were placed. The bonds themselves are bearer certificates held in mandatory centralized storage at the National Depository Center. Secondary market circulation of the bonds is on the OTC market and on the Moscow Interbank Currency Exchange. The first bonds were issued on October 24, 2002.

ADVISORS

After approaching several advisors, KMB chose Raiffeisen Bank to arrange and underwrite the deal. Not only was Raiffeisen one of the most experienced in structuring ruble bond offerings, but it also appreciated the strong underlying fundamentals of KMB's MSME business. Therefore, although the initial bond issue was relatively small for the Russian market, Raiffeisen recognized the potential for developing a long term relationship with KMB as KMB continued to grow.

RATING

As was noted, KMB's international rating from Moody's is Ba3 for long term bank deposits. Its domestic rating, provided by Moody's local Russian partner, the Interfax Rating Agency, is A1 for long term transactions and RUS-1 for short term transactions. These are the highest domestic ratings available from the Interfax Rating Agency.



PRECONDITIONS FOR ISSUANCE

The key precondition for issuance was registering the Security Issue Prospectus with the Central Bank of Russia. Following the issue, it was also necessary to register the Results of Security Issuance with the Central Bank.

In terms of the logistics of the transaction, KMB provided Raiffeisen with the information necessary to prepare an investment memorandum. This included KMB's audited IAS financial statements and information about the bank's business, products, strategy, management, etc. Raiffeisen produced the memorandum and provided it to potential investors. The time required between signing the mandate letter and issuing the first bonds was approximately ten weeks. The key people involved from KMB were the CFO, CEO, chief lawyer and treasurer, who spent a total of approximately 16 weeks on this first transaction.

4. Offering Process

PRICING

The total issue was valued at RUR 280,000,000, which was split into 280,000 bonds with a par value of RUR 1,000 each. The bonds had a maturity of three years, with a coupon rate of 15 percent per annum and a put option at 6 months.

DISTRIBUTION AND PLACEMENT PROCESS

Raiffeisen arranged for three additional co-arrangers and co-underwriters to participate in the transaction, as well three other co-underwriters, all of which were Russian banks.

The bonds are bearer certificates held in mandatory centralized storage at the National Depository Center. Secondary market circulation of the bonds is on the OTC market and on the Moscow Interbank Currency Exchange.

REGISTRATION PROCESS

Registration is with the Central Bank of Russia.

LISTING OF BONDS

The bonds are not listed.

5. Post Issuance Experience

There have been no redemptions of KMB's debt. In fact, there appeared to be sufficient demand to increase the size of the issue, but this was not possible due to the capital constraint noted earlier. In any case, the positive reception for the bonds encouraged Raiffeisen to lengthen the put period to one year. As of February 1, 2004, the yield on the bonds is 12 percent, representing KMB's growing reputation in the market as well as a decline in ruble interest rates.

DEBT SERVICE OBLIGATIONS

On Oct. 23, 2003 KMB paid RUR 21 million to settle the second coupon for its first bond issue. The payment per bond was RUR 74.79.



DISCLOSURE OBLIGATIONS

KMB is required to publish quarterly financial statements in the mass media. It is also required to provide the central bank with an extended quarterly report.

SECONDARY MARKET ACTIVITY

Turnover for the first six months of 2004 has been 40 percent of the issue. This level of turnover is considered to be positive for such a relatively small issue, because it reflects a high level of liquidity.

CONCLUSIONS AND LESSONS LEARNED

The first bonds were issued October 24, 2002 and the issue was fully subscribed. Demand was higher than expected and the yield on the initial placement was 18 percent, well within the 18-21 percent average for similar issues. To put these figures in perspective, the ruble inflation forecast for the year was 14 percent and KMB's ruble lending rate was in the 24 percent range

In addition to providing KMB with much needed ruble funding, the ruble bond had the advantage of expanding KMB's reputation beyond its bi-lateral relations with individual lenders. This has been important for KMB's ability to arrange other funding, from expanding correspondent banking relations to a successful loan syndication in December 2003. This loan was arranged by Raiffeisen and included Citibank as well as several other international banks. The loan also included a ruble tranche, representing the development of other funding options in the ruble market that had not existed when KMB launched its debt issue in the fall of 2002.

The successful ruble bond issue has also helped propagate the success of KMB's MSME lending model, which is important for the overall development of the MSME lending market.



CASE STUDY #2: ISSUANCE OF MORTGAGE BONDS IN BULGARIA

PROCREDIT BANK BULGARIA: INCREASING ACCESS TO CAPITAL FOR MICRO, SMALL, AND MEDIUM ENTERPRISES

1. Overview

THE ISSUER

ProCredit Bank Bulgaria was founded in June 2001. The Bank's aim mission is to provide access to financing for micro, small and medium-sized enterprises (MSME) in Bulgaria, in a flexible and dynamic way. The Bank was established in response to the fact that the MSME sector in Bulgaria faced (and still faces today) substantial problems in obtaining financing for investments and gaining access to credit for their daily business activities.

ProCredit Bank Bulgaria is part of a network of financial institutions which has almost 20 members worldwide. The Bank is owned by international financial institutions specializing in extensive lending and other banking products and services. Shareholders include development oriented financial institutions including the International Finance Corporation (IFC), the European Bank for Reconstruction and Development (EBRD), KfW Banking Group (Kreditanstalt für Wiederaufbau) and the German development organization DEG (Deutsche Investitions und Entwicklungsgesellschaft), as well as private investors such as German bank Commerzbank and Internationale Micro Investitions Aktiengesellschaft (IMI). The Bank is headquartered in Sofia with a branch network which has expanded so that it now covers nearly all cities and towns throughout Bulgaria, and employs more than 400 staff.

The Bank has demonstrated dynamic growth since its inception. Its development strategy is oriented to consistently branching out and diversifying products and services offered to its customers, with an emphasis on catering to individual needs while maintaining its competitive position relative to other banks in the local market. Since the Bank's founding, it has rapidly introduced a wide range of additional services tailored to the needs of its target SME sector, including savings and deposit programs, domestic and international money transfers, documentary business, debit cards and internet banking and, therefore, has now developed into a full-fledged commercial bank.

In January 2005, ProCredit Bank Bulgaria was named as the most dynamically developing bank in Central Europe, according to a survey conducted by the English magazine *The Banker*. The analysis comprised 377 banks from all former socialist countries in Europe. ProCredit Bank Bulgaria was at the top of the list of the 50 most dynamic banks in Central Europe.

THE NEED FOR BONDS

There is a growing demand for credit among MSMEs, most of which prefer to obtain this credit in local currency. To be able to service the MSMEs as well as to minimize their foreign currency risk, a mortgage bond issue was seen as the best option for ProCredit Bank. Moreover, the use of mortgage bonds as a funding source was meant to diversify the Bank's funding structure and also promote the image of the Bank as an equal participant in the Bulgarian financial market. Prior to this mortgage bond

Summary of Deal

Country:	Bulgaria
Issuer:	ProCredit Bank Bulgaria
Offering Type:	Mortgage Bond; private placement, with public trading on secondary market
Amount:	BGN 10 million (\$6.2 million) in two tranches of BGN 5 million, 7.125% p.a.
Issue Date:	April 15, 2003 (1 st tranche)
Maturity:	Three years



issuance, ProCredit Bank mainly obtained financing through credit lines from IFIs, the Bank's main shareholders. In view of the growing interest in the credit products and bank services of ProCredit Bank, the Bank expanded its branch network to Veliko Tarnovo, Pernik, Kardzhali, Asenovgrad, and Kazanluk.³ Thus, the issue of mortgage bonds will help to finance ProCredit Bank's expansion of banking activities.

THE LOCAL BOND MARKET

Bulgaria emerged successfully from the financial crisis of the mid-1990s to a point where the financial system is now stable, and the country is on track to achieve real and sustainable economic growth. The improved macroeconomic and financial sector outlook has led to the need for new products in the financial sector to ensure cheaper sources of financing for both lenders and borrowers.

First, the investor base is rapidly expanding. Second, there is a growing demand for debt instruments overall. Demand from mutual and pension funds is high; pension funds are the main institutional investor in Bulgaria and one of the major players in the market. Third, relevant legislation (securities, pension reform, mortgage bonds, etc.) has been put in place. Additionally, mortgage lending is booming; therefore, rapid growth of the secondary mortgage market is expected. Finally, multilaterals are providing liquidity to debt issuers.

The mortgage market in Bulgaria around the time of the issue (April 2003) had a total volume of EUR 30 million with a total of only 7 issues.

2. Barriers, Constraints, and Opportunities

KEY ISSUES AFFECTING MARKET

Despite several positive trends and developments, constraints exist that have prevented the market from developing more rapidly and with more depth. One problem is that while legislation exists, laws and regulations are not enforced, so there is a high level of non-compliance. This "non-compliant" environment keeps investors away. Another problem is the lack of unified standards, which is common throughout the South-East Europe (SEE) region. Harmonization of standards, particularly with respect to the secondary debt market, could and should be done throughout the SEE region. Another problem stems from the small size of banks' mortgage portfolios. The average size is EUR 20-50 million, which is too low to securitize. As a result, issuers cannot access international markets, so they issue in domestic markets, which is significantly more expensive. Therefore, there is a strong need to find a bridge to international capital markets. Finally, there is also a need to develop risk assessment skills. These skills can be learned from neighbors within the region and beyond, transferring knowledge between countries and within sub-regions.

LEGAL/REGULATORY ISSUES

At the time of the offering, the limitations related to corporate debt issuance in the country, and issuance of mortgage bonds in particular, were established by the Mortgage Bonds Act of October 2000 as well as the Law on Commerce and Law on Banks. According to the latter two, bonds can only be issued by joint-stock companies and banks can issue bonds denominated in Bulgarian Lev (BGN) or another currency.

In recent years, interest in mortgage-backed securities as a source of long-term funding on the part of Bulgarian commercial banks has been growing. This is due to the fact that lending activities of banks

³ www.procreditbank.bg



have developed extensively during this period. In addition, Bulgarians have revised their conservative approach to accessing credit and have begun to think in a more flexible fashion.

In order to maintain liquidity and ensure more on-lending, banks have started searching for alternatives in financing the growing demand for all types of loans. As a consequence, the Mortgage Bonds Act was constituted to regulate such activities and ensure prospective buyers of these securities against events of default on the part of issuing banks. The Act contains, inter alia, special provisions with regard to the mortgage bonds cover consisting of loans secured with first priority pledge on real property. It also defines methods of calculation of the main cover and methods of mortgage appraisal. The law obliges issuing banks to establish internal rules on maintaining a cover register, access to information contained in the register, and on how to carry out and file mortgage appraisals. These requirements have not been changed in the meantime, and also no particular barriers have been set up in general to corporate debt issuance. On the other hand, looking towards possible investors, there are legal restrictions for pension companies' investments, including banks' mortgage bonds. Pension funds can only invest up to 30% of their total assets in mortgage bonds and only 10% of their assets can be with one bank. Pension funds are limited to investing up to 20% of their assets in corporate bonds of Bulgarian issuers traded on regulated markets and up to 10% in securities of one company.

KEY ISSUES SPECIFIC TO THE ISSUER

There was some initial concern about how the market would accept this initial offering of mortgage bonds from ProCredit Bank and where the bonds would be placed successfully. In fact, with its fast and steady development, the Bank had already achieved an image of a well-managed financial institution and a reliable partner, and the investment intermediary had accumulated sufficient experience as such with other banks' bond issues. Thus, these issues were not seen as a major impediment to the deal.

3. Deal Assembly and Structure

DEAL STRUCTURE

After considering various strategies, the issue was divided into two tranches. The preparation for the first tranche took about a month, while the second tranche took only two weeks. Both tranches were initially offered to private investors. Once the primary offer for both tranches was complete, the issue was prepared for listing on the Bulgarian stock exchange to allow public trading on the secondary market. This approach was chosen as it would provide consistency between primary and secondary market trading, as required by common practice. The strategy to pursue a private followed by a public offering was pursued because (1) the Bank lacked experience with the public market and needed time to familiarize itself with the market, (2) a private offering was cheaper and faster, and (3) a private issue required significantly less disclosure of financial information.

The total time for preparation and issuance took about one and a half months. The Bank enjoyed significant interest with regard to the intermediation of its first issue, receiving three offers from commercial banks and investment companies.

ADVISORS

Biochim, a major Bulgarian commercial bank, the fourth largest in the market, was selected to be the lead manager of the issue. They prepared the prospectus of mortgage bonds subscription under the conditions of private offering and presented it to potential buyers. TBI Invest EAD (member of TBI Holding Group, in which EBRD has equity participation) served as co-manager, acting as an investment intermediary primarily during the listing on the Bulgarian stock exchange.



The preparatory proceedings in both cases ended with the full subscription of the issue by CB Biochim. An option was available for the Bank to place the bonds at its own risk, without using other's intermediation, but that option was not chosen.

RATING

At the time of the issue, the Bank had not been assessed by international credit rating agencies. However, upon an inspection on the part of the Bulgarian National Bank in December 2002 the Bank was given credit rating 1 under the CAMELS framework. Since then, the Bank has been assessed. In September 2004, Fitch international rating agency assigned a BB+ rating to ProCredit Bank on long-term liabilities and B rating on short-term liabilities.

PRECONDITIONS FOR ISSUANCE

A prospectus was one of the preconditions for issuance. The Bank had to provide audited financial statements for the past two years of operations (2001 and 2002). In addition, the bank was required to submit a risk profile, including a systematic risk characterization of the macroeconomic environment, such as overview of inflation tendencies, the country's credit risk, foreign currency risk, as well as risks specific to the Bank's operations, such as credit risk, market risk and interest rate risk. The Bank also provided up-to-date liquidity indicators and information on its outstanding portfolio, particularly pertaining to the pool of mortgage loans serving as cover for the issue.

There were other preconditions set by the Bank's shareholders. Internally, at a Board meeting, an offer from HVB Bulgaria was presented for placement of the issue. A comparison of costs from different sources of medium term BGN funding was presented and the rationale for a mortgage bond issue was demonstrated. In this context, the growing importance of private pension funds for the Bulgarian capital market was emphasized.

Shareholders KfW and the IFC insisted on either a negative pledge clause in the loan agreements with the Bank or a *pari passu* clause, guaranteeing equal treatment of all investors in terms of provision of security (such as a mortgage portfolio). In contrast, the EBRD supported the project for the following reasons: 1) raising domestic capital was felt to be superior to relying on donor financing; 2) Bulgarian funding is required to finance micro lending; 3) such an initiative would contribute to the development of capital markets. Therefore, a waiver for the negative pledge clause in regard to the proposed mortgage bond issue was arranged.

At a subsequent Board meeting, the Board unanimously authorized management to proceed with the proposed mortgage bond issue. The Board also approved a rule restricting total issues of mortgage bonds to 10 percent of the Bank's total assets.

Following management discussion with IFC and KfW, an addendum was signed establishing conditions for the mortgage bond issue. These conditions were reviewed with regard to the risk margins, which were increased by 25 basis points.

4. Offering Process

PRICING

On April 15, 2003, the issue was successfully launched and fully subscribed. The total issue was valued at BGN 10 million (EUR 51 million), which was split into two tranches each of BGN 5 million. The bonds have a 3-year maturity, with a fixed interest rate of 7.125% per annum. The second tranche was issued on November 20, 2003.



DISTRIBUTION AND PLACEMENT PROCESS

At a supervisory board meeting in September 2002, Bank management presented an offer from HVB Bulgaria for placement of a mortgage bond of BGN 10 million. A comparison of costs from different sources of medium term BGN funding was presented and the rationale for a mortgage bond issue was demonstrated. In this context, the growing importance of private pension funds for the Bulgarian capital market was emphasized.

KfW and IFC insisted on either a negative pledge clause in the loan agreements with the Bank or a *pari passu* clause, guaranteeing equal treatment of all investors in terms of provision of security (such as a mortgage portfolio). In contrast, the EBRD supported the project for several reasons, including: 1) belief that raising domestic capital is superior to relying on donor finance, 2) BGN funding is required to finance micro lending, 3) this initiative would contribute to the development of capital markets. Therefore, a waiver for the negative pledge clause in regard to the proposed mortgage bond issue was arranged.

At the next Supervisory Board meeting in January 2003, after addressing the concerns of all of the parties, the Board unanimously authorized the Bank's management to proceed with the proposed mortgage bond issue within preset parameters which were strictly observed. They also approved a rule restricting total issues of mortgage bonds to 10% of the Bank's total assets.

Following management discussion with IFC and KfW, an addendum was signed establishing conditions for the mortgage bond issue. These conditions were reviewed with regard to the risk margins, which were increased by 25 basis points.

Initially the mortgage bonds were placed under conditions of private offering. They were subsequently listed for free trading on the secondary market. Both tranches were distributed primarily among Bulgarian insurance companies and pension funds, as well as other investors, including two commercial banks.

REGISTRATION PROCESS

The bonds were registered with the Bulgarian National Bank.

LISTING OF BONDS

The bonds are listed on the Bulgarian stock exchange to allow trading on the secondary market.

5. Post Issuance Experience

DISCLOSURE OBLIGATIONS

Disclosure obligations were in line with normal Bulgarian regulations regarding disclosure. This required preparation of a prospectus under the conditions of private offerings.

CONCLUSIONS AND LESSONS LEARNED

The issue went according to plan. The first tranche was distributed among primary Bulgarian insurance companies and pension funds. The second tranche too was bought in large part by pension funds and other investors (two commercial banks among them). The terms of the initial subscription agreement between the Bank and the investment intermediaries were followed and observed. The minimum "Cover to Issue" ratio set at 1:1 has been regularly monitored and maintained on a quarterly basis as required. ProCredit Bank Bulgaria's management was pleased with the results of this initiative. The issue was positioned well, the needed funds were raised fast and the institution has since received favorable interest



and attention from market makers and investors. This favorable attention should produce good opportunities for building new partnerships.

Of note, this mortgage bond issue paved the way for ProCredit Bank Bulgaria to launch and complete a second successful mortgage bond issue, with the solid backing and approval of its Board. On February 27, 2004, ProCredit Bank Bulgaria proceeded with the second issue of mortgage bonds with a total value of BGN 10,000,000 (EUR 51 million). Raiffeisen Bank was the lead manager of the issue and CB Allianz Bulgaria was the co-manager. The bond issue has a three-year maturity at a fixed interest rate 6.25% per annum, payable semi-annually. Initially the mortgage bonds were placed under conditions of private offering. They were subsequently listed for free trading on the secondary market. The nominal value of each bond is BGN 1,000.

The mortgage bond issue will fund the main activity of ProCredit Bank Bulgaria, namely, lending to MSMEs. *The two successful mortgage bond issues of ProCredit Bank Bulgaria AD have helped to meet the increasing credit needs of micro, small and medium enterprises in Bulgaria.*



CASE STUDY #3: MODIFIED SPECIAL PURPOSE VEHICLE STRUCTURED BOND PLACEMENT IN RUSSIA

AMTELSHINPROM, LLC: DEVELOPING INNOVATIVE METHODS TO FINANCE INVESTMENT ACTIVITIES

1. Overview

THE ISSUER

Established in 1990, Amtel Group is the second largest tire manufacturer in Russia. The Group's consolidated turnover exceeds US\$350 million, with assets over US\$430 million. At present, Amtel is a vertically-integrated petrochemical holding that controls almost 30 percent of the Russian tire market. In particular, Amtel holds 35 percent of the passenger car tire market, while its share in the earthmover, aviation and motor-tire segments reaches between 80-100 percent.

Amtel has a diversified client base that includes manufacturers of passenger cars and buses, and a distribution network of over 200 dealers. The holding's work force exceeds 25,000 employees.

The Amtel brand belongs to Amtel Holdings Company, LLC, which has administrative functions and is not engaged in tire manufacturing.

Summary of Deal

Country:	Russia
Issuer:	Amtelshinprom, LLC
Offering Type:	Modified SPV structured placement
Amount:	RUR 600,000,000 (\$21 million)
Issue Date:	December 27, 2002
Maturity:	3 years

Overall, the Group's strategy is aimed at increasing production efficiency through greater specialization. Management intends to transform Amtel from a vertically-integrated petrochemical holding into a specialized tire company, which will ensure better utilization of competitive advantages in the tire manufacturing business. The sale of Chernigov Khimvolokno Plant (Ukraine) was the first step in this direction.

THE NEED FOR BONDS

Prior to the bond issue Amtel's activities were financed mainly by its shareholders. In order to smooth its debt portfolio and to lessen the liability of its shareholders, Amtel decided to pursue a bond issuance. The borrowed funds were to be used to finance the Group's operating activities. At the time of the issue, the Group's plants were implementing investment projects in the amount of around \$60 million.

THE LOCAL BOND MARKET

The debt markets in Russia are dominated by dollar financing. As maturities are lengthened and syndicated loans are increasing, financing is expanding from large and medium sized corporations – which borrow 70% and 50% in dollars respectively – to small and medium enterprises. Other attractive options for borrowers are Eurobonds, which also provide longer maturities at favorable rates.

Ruble denominated lending, while increasing, is still hampered by a lack of liquidity and relatively few institutional investors. In the ruble debt market, the largest five borrowers account for between 40-50% of turnover in bonds. Russia continues to be plagued by a lack of corporate transparency and a burdensome bureaucracy. The preparation period for issuing bonds averages three to five months.

There are signs of improvement, however. The Federal Security Commission is working on regulations to streamline the process for bond issuance. Reporting requirements, aimed at improving corporate transparency, are becoming more stringent. In addition, the number of bond issues and issuers is increasing, and underwriters are abundant. Western banks have begun to set up local operations.



2. Barriers, Constraints, and Opportunities

KEY BUSINESS/ENVIRONMENTAL ISSUES AFFECTING THE MARKET

Around the time of preparation of this issue, the market in Russia was saturated. A medium-sized bond issue (R600 million) was offered after large-scale placements by the most reliable borrowers. At about the same time, other large issues had absorbed most investor demand for corporate bonds.

LEGAL/REGULATORY ISSUES

The Group initially planned that one of its largest plants would act as a guarantor. However, provision of a guarantee covering the entire issue amount or its largest part in a volume of more than 100% of total assets required compliance with Russian laws for the approval of large deals. In particular, one of the necessary requirements was unanimous approval of the deal by the plant's Board of Directors, which was not received. Furthermore, the large deal (guarantee) was not approved by 75% of voting shares. All of these obstacles forced the issuer to reject the initial guarantee scheme.

KEY ISSUES SPECIFIC TO THE ISSUER

Amtel faced a host of barriers in the period prior to and during the bond issue. From internal management and ownership struggles, to legal restrictions and poor timing, the bond issuance was an uphill battle. Some of the challenges faced by Amtel are elaborated upon below.

There were two primary issues and two secondary issues of concern. A primary issue was that the Group maintains a complex ownership structure. At the time of the first bond issue, the Group launched a restructuring process while the Holding's legal ownership structure was still unclear. This structure necessitated a guarantee and a double put option. A second main issue was that the Amtel Group lacked a public credit history, which complicated its market positioning. A secondary issue was that Amtel Group's management insisted that the placement occur before the end of 2002, which shortened the time frame for preparation of the necessary documentation. Related to this, the placement of the issue was executed in December – a period when annual balance sheets are closed and a period traditionally marked by a severe liquidity deficit and the subsidization of investment activity. Despite the use of a private placement mechanism, the range of potential investors was not strictly determined (all MICEX members were admitted). Combined with an unfavorable placement period, this threatened the outcome.

3. Deal Assembly and Structure

DEAL STRUCTURE

Acting as organizer and underwriter, Alfa Bank was responsible for developing the issue's structure and preparing the standard documentation. The composition and behavior of the Russian bond market played a large role in determining the nature of the placement. The structure of the deal was typical for the Russian market. Uncharacteristic of the market, the coupon rate was fixed until maturity. The rationale behind the coupon rates was due to expectations of price growth on the corporate bond market. As a result, issue structures often included a clause that the coupon rate would be determined at an auction and fixed only until the put option date, as issuers expected a further drop in yields. In cases when the coupon rate was fixed until maturity, the issuers used a regressive scale. The fixed coupon rate of Amtel's issue, which would not change until maturity, allowed the following:

- Estimation of the issuer's future cash outflows, which were crucial to determine the project's payback period;
- Successful placement results in spite of the fact that the issuer was "unknown" to the market, and the placement was executed at the end of the financial year;
- Minimization of costs during the first stage, as the issuer expected proceeds to grow in later periods.



Innovative use of a Modified SPV Structure: Amtel's bond issue scheme resembles an SPV (Special Purpose Vehicle) structured placement. This modified SPV structure was used in order to overcome various legal, regulatory and operational barriers. However, the company-issuer is currently an operational entity, which goes beyond the classic SPV scheme. At the time of the first bond placement, Amtel had a sophisticated organizational structure, which required both a guarantee and a double put option for the bond issue. The newly created trading company, LLC Amtelshinprom, acted as an issuer. A 60 percent stake in Amtelshinprom is controlled by Amtel Holdings Company, with the balance held by other companies within the Group. When the decision to issue bonds was made, LLC Amtelshinprom was not an operational entity. In order to boost trading efficiency, the Group began to transfer its procurement and distribution operations from Amtel-Neftekhim and AmtelShinTorg to LLC Amtelshinprom in November 2002. The guarantees were provided by Amtel Holdings Company, which owns controlling stakes in several plants and trading companies within Amtel Group. A put option was offered on behalf of two companies: Amtel Holdings Company and OJSC Khimvolokno Amtel-Kuzbass, with the latter being Russia's largest producer of synthetic fiber and also part of Amtel Group. The put option obligations of OJSC Khimvolokno Amtel-Kuzbass were to take effect should Amtel Holdings Company fail to execute the preliminary buy-back (put option). Thus far, the put obligations of OJSC Khimvolokno Amtel-Kuzbass have acted as an additional guarantee for investors.

ADVISORS

AlfaBank was the main organizer and underwriter. Troika Dialog served a co-manager and underwriter and Promsvyazbank served as an additional underwriter.

RATING

At the time of the issue, Fitch ratings for the main organizer and under writer, Alfabank were B+ for long term and B for short term. At the time of the issue, Amtel was not rated by an international rating agency.

PRECONDITIONS FOR ISSUANCE

The precondition for issuance was the preparation of a standard document package. This package included a Prospectus, Decision, and Placement Results Report.

4. Offering Process

PRICING

The issue was valued at a total of RUR 600 million (US\$21 million). The placement price was equal to par value of RUR 1,000. The bonds had a maturity of three years, with the first coupon rate set at auction at 19 percent per annum and fixed until maturity. The second coupon rate, also set at auction, was 15.95 percent. The bonds had a put option at 12 months.

DISTRIBUTION AND PLACEMENT PROCESS

There are two types of bond placements, one as an auction for price and another as an auction for coupon rate. This issue was placed as an auction for coupon rate. The bonds are coupon bonds held in mandatory centralized story at the National Depository Center.

REGISTRATION PROCESS

The bonds were registered with the Federal Securities Commission (FSC) of Russia.

LISTING OF BONDS

The bonds were listed on the Moscow Interbank Currency Exchange (MICEX).



5. Post Issuance Experience

Experience gained from the first issue facilitated the organization of the second placement in the amount of RUR1.2 billion. Due to the success of the first issue, by the time of the second issue, Amtel Group was “well known” on the market, while the yield guidelines were already set. Additionally, market players already had credit limits for Amtel bonds. As a result, the second issue placement was also closed within one day. The coupon rate was set at auction at 15.95 percent p.a., which met the issuer’s expectations and was in line with the market level.

DISCLOSURE OBLIGATIONS

Disclosure obligations as prescribed by Russian law on securities markets were observed. This requires all issues to publish quarterly financial reports in the mass media, as well as offering prospectus.

SECONDARY MARKET ACTIVITY

Trading on the secondary market began in February 2003 on the Moscow Interbank Currency Exchange (MICEX).

CONCLUSIONS AND LESSONS LEARNED

The issuance was a success, with the entire issue amount placed within one day, for both issues. Amtel’s first bond issue was one of the most liquid instruments among second-tier corporate bonds. The market price of Amtel bonds was such that there was no buy-back. Further, the availability of a public credit history favored the sale of an approximately 4 percent stake to an external investor (Templeton Strategic Emerging Markets Fund).

Thus, the construct and successful implementation of a modified SPV structure allowed Amtel Group to raise funds to finance its various investment projects.



CASE STUDY #4: LOCAL CURRENCY PUBLIC BOND ISSUE IN POLAND

TELEKOMUNIKACJA POLSKA SA: BLAZING A TRAIL IN CORPORATE PUBLIC DEBT ISSUANCE

1. Overview

THE ISSUER

Telekomunikacja Polska SA (TP) is a dominant entity in Telekomunikacja Polska Group (TP Group) - the principal supplier of telecommunications services in Poland and one of the largest telecommunications companies in Central Europe.

Listed on the Warsaw Stock Exchange, TP Group provides leased lines, radio communication and other telecommunications value added services and sells telecommunications equipment. It also produces fiber optic cables and chip cards and supplies services in the areas of Internet, data transmission and multimedia.

Summary of Deal

Country:	Poland
Issuer:	Telekomunikacja Polska SA
Offering Type:	Public Zloty Issuance
Amount:	PLN 1 billion (\$261 million)
Issue Date:	December 9, 2002 (PLN 300 million issued)
Duration:	3 years, 7.25 % p.a. fixed annual coupon

Fixed line telephone services (including local, domestic and international long distance) constitute a major part of TP activities. TP has a 90% market share (10.5 million subscribers) in fixed line telephony in Poland. It also has a 33% market share in the mobile telephony market in Poland through its subsidiary PTK-Centertel. TP is one of Poland's three mobile telecommunications providers and the country's only NMT 450 mobile telecommunications provider.

THE NEED FOR BONDS

Before deciding to issue corporate bonds on the local Polish market, TP had been using various types of financing: short, medium and long term credit lines; private placement local bonds; Eurobonds; and European Investment Bank (EIB) credits. TP decided to tap the local market with a medium-term public bond issuance based on favorable regulatory conditions and encouragement from Bank Handlowy (BHW), a member of Citigroup.

BHW arranged the first public long-term corporate bond program for the Polish market. Its PLN 3 billion offering for the EIB – launched in October 2001 – was instrumental in paving the way for legislative changes that simplified the process for arranging corporate public bond offerings and was critical to the development of a long-term corporate public bond market in Poland. To help ensure the growth of the market, BHW encouraged TP – a company with wide name recognition, financial sophistication and significant capital capacity – to pursue a public issuance.

THE LOCAL BOND MARKET

The local debt market is dominated by government debt, which accounts for 90 percent of the market. The structure of non-government debt is dominated by commercial paper, followed by corporate bonds, municipal bonds, and bank bonds. The share of commercial paper issues in the market is about 48 percent, with some 215 issuers. Corporations which issue long-term debt account for 28 percent of the market, with 63 issuers. By comparison, municipal debt amounts to 12 percent, with about 206 issuers.



There are two main reasons why commercial paper dominates the market. First, the high interest rate environment of the past few years has made issuers reluctant to finance using long-term debt --- issuers want to play the yield curve. Second, until recently, there was no secondary market for commercial paper, which meant that investors who bought commercial paper had a difficult time selling the debt. Recently, the situation has been changing, with the result that there have been a number of public issues that have been floated on the OTC market.

The main investors in the public market are pension funds (35%), followed by banks (28%), insurance companies (25%), and investment funds (12%), respectively. The main investors in the non-public market are corporations (61%), banks (19%), and insurance companies (12%), as well as other financial institutions (8%) respectively. Polish regulations allow for three types of placement options: public offers, quasi-public offers, and non-public or private placements. 99% of corporate issues are private placements.

2. Barriers, Constraints, and Opportunities

LEGAL/REGULATORY ISSUES

Recent changes in Polish legislation governing public bond issuance have simplified disclosure requirements for publicly listed companies. One stipulation is that these companies must direct their offering to a Qualified Investors' Group (QIG). QIG is a category of investors, recently introduced in Polish regulations that include among others, brokerage houses, banks, insurance companies, investment funds, and pension funds. When these entities accept an offer to buy bonds, they agree to invest a minimum of EUR 100,000. As TP fulfills strict disclosure requirements to the Warsaw Stock Exchange, the preparation process of its Issue Prospectus was simplified significantly. Due to this and other changes in the legal regulations regarding public bond issues for corporations, organizing public bond programs for issuers other than the Polish government and the EIB has become more feasible and more common.

According to the Polish Act on Public Trading on Securities, passed in August 1997, there are 2 ways of introducing bonds for public trading:

- by notification to SEC (no need for SEC approval – papers are deemed to be admitted to the public trading after 30 days after the notification was sent)
- by application to SEC (SEC approval required within 30 days).

KEY ISSUES SPECIFIC TO THE ISSUER

The overall bond program was valued at PLN one billion. The initial issue of PLN 300 million - represented nearly 5% of total issuances for 2002. This was the first deal of this size to be issued in Poland. Because the issuance was so large, BHW had unique challenges to market, advertise, and arrange the deal.

Beyond this, the listing process with the SEC – TP was advised to use the application rather than the notification process – and the negotiation on price quotes and other details with CeTO – the Polish over the counter market - went smoothly.

3. Deal Assembly and Structure

DEAL STRUCTURE

Bank Handlowy a member of Citigroup structured and marketed the first issuance under the Program, which received a very good response from investors and enabled TP to obtain 3-year financing for the



first issue under the program in the amount of PLN 300 million. The deal was structured as a private placement.

ADVISORS

Apart from BHW (as the Arranger, Issuing Agent, Paying and Calculation Agent) and Brokerage House of BHW (as the Offeror), a legal advisor was hired to co-ordinate the documentation preparation and to represent the Issuer at the Polish SEC admission proceedings.

Additionally, Bank Handlowy - a member of Citigroup - organized a very efficient marketing process for the public bond program. This road show mainly involved one-on-one meetings with potential investors and presentations to groups of investors.

RATING

TP is BBB (stable) rated by Standard & Poor's and Fitch, and Baa2 (negative) by Moodys. This rating reflects, "TPSA's dominant position in the fixed-line segment, growing contribution from its mobile operations, strong core case flow generation and management commitment to prudent financial policies. The ratings remain constrained by challenging operating environment and regulatory risks, as well as growing competition in both fixed-line and mobile segments."⁴

PRECONDITIONS FOR ISSUANCE

TP was required to develop a prospectus, which contained basic information about the company and its activities, a description of risks, and links to financial statements.

4. Offering Process

PRICING

The total value of the bond offering was PLN 1 billion (\$261 million). The bond offering had a fixed coupon rate of 7.25 percent per annum. The initial issue was valued at PLN 300 million. The bond had a maturity of three years. The bonds were priced at 197 basis points over Treasury bonds, i.e. 189 basis points over WIBOR, piercing the existing curve. The issue price was PLN 1,000.

The book-building process of public bonds of TP took place simultaneously with the Monetary Policy Council session. Market participants expected an interest rate cut of approximately 50 basis points. Bank Handlowy advised TP to access the market with the debut public issuance before the announcement of the Council's decision. This strategy appeared to be very beneficial for the Issuer as the interest rates fell only by 25 basis points and the market reacted with re-pricing of bonds and on raise of their yield by 40 basis points.

DISTRIBUTION AND PLACEMENT PROCESS

The road show related to the public bond offering took place in November 2002 and apart from the general presentation it included also one-on-one meetings with the main institutional investors in the Polish corporate debt market. The bond road show coincided with the road show for TP equity investors to announce TP third quarter results. These events enabled TP to present its achievements to date and address a number of issues connected with TP perception on the market. These meetings contributed to

⁴ UBS Investment Research, Telekomunikacja Polska SA, May 20, 2004.



the success of TP Public Bond Program, increasing investors' confidence in the investment in TP securities.

REGISTRATION PROCESS

The bond program was registered with the Polish securities and exchange commission through an application process (described above).

LISTING OF BONDS

The bonds were listed on CeTO, the Polish over-the-counter market.

5. Post Issuance Experience

DISCLOSURE OBLIGATIONS

Disclosure obligations of public bond issuers in the Polish market are basically the same as the disclosure for companies whose shares are publicly listed on the Polish stock exchange. They require development and circulation of an offering prospectus, which contained basic information about the company and its activities, a description of risks, and links to financial statements.

CONCLUSIONS AND LESSONS LEARNED

The road show proved to be a very efficient helpful in finding investors. Seventy percent of potential investors taking part in the road show decided to subscribe for bonds, which resulted in the oversubscription. The bonds were allocated to institutional investors, mainly to asset management funds. More than half of the bonds were allocated to the biggest investors, which placed orders for above PLN 30 million.

The process for debt issuance established by Bank Handlowy and EIB was instrumental in creating the space and the market for TPSA's bond program. The streamlined disclosure process and the development of a QIG served to increase the demand of Polish investors for medium term debt, and the TPSA issue opened the door for other corporations to issue bonds and improve the liquidity of the market. Additional liquidity could be achieved through additional listings and the development of a secondary market traded on an electronic platform. Increasing the limits of institutional investors would also improve market liquidity.

The PLN 1 billion public bond program for TP and arranged by BHW was a landmark transaction in Polish capital markets. It was first sizeable medium and long term corporate public bond program and, at the same time, first public bond program directed to the Qualified Investors Group. Besides meeting corporate expectations, the program blazed a trail for other issuers planning to list on the public bonds market, and set a standard for the arrangement of bond issues.



*For Additional Information
on the Debt Markets Development Initiative,
please contact:*

MR. HUGH HAWORTH

Senior Financial Market Advisor

USAID

EE.EG.MT, RRB 5.08.134

1300 Pennsylvania Avenue, NW

Washington DC 20523-5701

USA

Tel: +1 (202) 712-0118

Fax: +1 (202) 216-3377

Email: Hhaworth@usaid.gov

MS. CHARU V. ADESNIK

Senior Manager, Financial Sector Development

Emerging Markets Group, Ltd.

1001 G Street, NW

Suite 900 West

Washington, DC 20001

USA

Tel: +1 (650) 462-1962

Fax: +1 (202) 661-1096

E-mail: calesnik@emergingmarketsgroup.com